



DELAWARE STATE LOTTERY

Financial Statements

June 30, 2008 and 2007

(With Independent Auditors' Report Thereon)

DELAWARE STATE LOTTERY

Table of Contents

	Page
Independent Auditors' Report	1
Management's Discussion and Analysis	3
Financial Statements:	
Balance Sheets	9
Statements of Revenue, Expenses, and Change in Net Assets	10
Statements of Cash Flows	11
Notes to Financial Statements	12
Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i>	23



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Independent Auditors' Report

Wayne Lemons, Director of the Delaware State Lottery, and
Richard S. Cordrey, Secretary of Finance, State of Delaware:

We have audited the accompanying balance sheets of the Delaware State Lottery (the Lottery) as of June 30, 2008 and 2007, and the related statements of revenue, expenses, and change in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1 to the financial statements, the financial statements present only the Lottery and do not purport to, and do not, present fairly the financial position of the State of Delaware as of June 30, 2008 and 2007, and the changes in its financial position for the years then ended, in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Delaware State Lottery as of June 30, 2008 and 2007, and its changes in financial position and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in note 1(l), the Lottery adopted the Provisions of Governmental Accounting Standards Board Statement (GASB) No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 15, 2008, on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.



Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplemental information. However, we did not audit the information and express no opinion on it.

KPMG LLP

December 15, 2008

DELAWARE STATE LOTTERY

Management's Discussion and Analysis

June 30, 2008 and 2007

The management of the Delaware State Lottery (the Lottery) offers this narrative overview and analysis of the Lottery's financial activities for the years ended June 30, 2008 and 2007, which should be read in conjunction with the Lottery's basic financial statements.

Overview of the Basic Financial Statements

This discussion and analysis is intended to serve as an introduction to the Lottery's basic financial statements. Since the Lottery is an enterprise fund of the State of Delaware, these financial statements are presented in a manner similar to a private-sector business. As required by accounting principles generally accepted in the United States of America (GAAP), current year's revenues are recorded when earned and expenses are recorded as they are incurred, regardless of when the cash is received or disbursed.

The balance sheet presents information on all of the Lottery's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets serve as a relative indicator of the change in financial position of the Lottery.

The statement of revenue, expenses, and change in net assets shows the result of the Lottery's total operations during fiscal 2008 and reflects both operating and nonoperating activities. Changes in net assets (increases or decreases) reflect the current fiscal year's operating impact upon the overall financial position of the Lottery.

The statement of cash flows provides a detailed analysis of all sources and uses of cash. The direct method of cash flows is presented, ending with a reconciliation of operating income to net cash provided by operating activities. The statement of cash flows is divided into three activities sections—operating, noncapital financing, and investing.

Notes to the basic financial statements contain additional information, and often offer explanations to the basic financial statements. The notes are intended to assist the reader in understanding the Lottery's basic financial statements.

DELAWARE STATE LOTTERY
Management's Discussion and Analysis
June 30, 2008 and 2007

Condensed Balance Sheets

Table 1
Balance Sheets
(In millions)

Assets	2008	June 30 2007	2006
Cash and cash equivalents	\$ 5.8	8.6	6.1
Accounts receivable, net of allowance of \$0.7, \$0.7, and \$0.7, respectively	14.9	12.5	8.7
Investments	4.7	6.6	8.5
Capital assets, net	—	—	0.1
Deposit with Multi-State Lottery	2.1	1.7	1.9
Total assets	<u>\$ 27.5</u>	<u>29.4</u>	<u>25.3</u>
Liabilities and Net Assets			
Liabilities:			
Prizes liability, including \$4.7, \$6.6, and \$8.5, respectively, of prize installment obligation	\$ 8.9	10.7	12.5
Accounts payable and accrued liabilities	9.7	8.5	5.8
Multi-State Lottery reserve	2.1	1.7	1.9
Due to the State of Delaware	6.3	7.5	4.1
OPEB liability	0.3	—	—
Total liabilities	<u>27.3</u>	<u>28.4</u>	<u>24.3</u>
Net assets:			
Invested in capital assets	—	—	0.1
Unrestricted	0.2	1.0	0.9
Total net assets	<u>0.2</u>	<u>1.0</u>	<u>1.0</u>
Total liabilities and net assets	<u>\$ 27.5</u>	<u>29.4</u>	<u>25.3</u>

The Lottery's accounting periods are predicated on a 4-4-5 week cycle except at year-end when the closing date includes additional days up to and including June 30. These extra days amounted to five in 2006, six in 2007, and eight in 2008. Correspondingly, the additional days in 2006, 2007, and 2008 are reflected in the additional accounts receivable.

Investments and the related prize installment obligations have been reduced over the years as a result of the maturing of existing annuities and the Lottery's discontinuation of annuities for prize payments.

DELAWARE STATE LOTTERY
Management's Discussion and Analysis
June 30, 2008 and 2007

Revenue

Table 2
Revenue
(In millions)

	Year ended June 30		
	2008	2007	2006
Play 3	\$ 26.8	26.9	27.6
Play 4	17.3	17.6	17.2
Multi Win Lotto	7.1	7.1	7.5
Raffle	1.0	1.0	—
Powerball	32.2	29.5	38.0
Powerplay	3.3	3.1	2.8
Hot Lotto	1.6	—	—
Instant games	35.6	33.1	31.4
Traditional games revenue	124.9	118.3	124.5
Video lottery, net	611.5	635.7	603.5
Video lottery machine license fees	0.9	1.1	—
Video lottery performance surcharge	4.2	—	—
Video lottery expired jackpots and credit slips	0.7	—	—
Total revenue	\$ 742.2	755.1	728.0

Table 2 above compares revenue for each lottery game category. Total lottery revenue from ongoing operations for fiscal year 2008 was \$17.6 million or 2.3% lower than for 2007 and revenue for fiscal year 2007 was \$26 million or 3.6% higher than for fiscal year 2006. A law was passed during fiscal year 2007 that enabled the Lottery to charge a video lottery machine license fee to each licensed venue that exceeds a total of 2,500 machines at their facility. This revenue is labeled "Video lottery machine license fees" above. The State of Delaware imposed a penalty on the tracks for not reaching forecasted performance goals. This penalty is reflected above under "Video lottery performance surcharge." The Lottery also collected unpaid jackpots and credit slips after their one-year expiration period.

Powerball sales are typically driven by the size of the jackpot. As a result, 2007 sales decreased \$8.2 million or 20.1% from 2006, since 2006 had two jackpots over \$300 million and fiscal year 2007 did not have any. Revenues rebounded in 2008 as the year had two jackpots above \$275 million.

Instant games continue to show a steady increase. The "cooperative services" agreement that the Lottery signed with its vendor for instant games continued to produce positive results. The vendor, in conjunction with the Lottery, continued to offer more attractive products. The Lottery also decided to shorten the life cycle of games offered and increased the introduction of higher price point tickets, as surveys indicated that higher price points with higher prize levels were more attractive to the playing public.

DELAWARE STATE LOTTERY

Management's Discussion and Analysis

June 30, 2008 and 2007

Video lottery continued its steady increase from 2006 to 2007 due to the addition of machines and the extension of operating hours. There was a \$24.2 million or 3.8% decline in video lottery revenues from 2007 to 2008. This was primarily due to the opening of a racino in Pennsylvania not far from Delaware Park, the State of Delaware's largest racino.

Cost of Games

Table 3

Cost of Games

(In millions and as a % of sales)

	Year ended June 30					
	2008		2007		2006	
Commission expense	\$ 298.8	40.3%	\$ 309.3	41.0%	\$ 295.6	40.6%
Gaming vendor fees and costs	43.1	5.8	43.9	5.8	40.8	5.6
Franchise game fees	4.2	0.6	3.1	0.4	2.0	0.3
Prize expense	65.9	8.9	61.3	8.1	64.9	8.9
Total cost of games	\$ <u>412.0</u>		\$ <u>417.6</u>		\$ <u>403.3</u>	

Commission expense includes payments to lottery retailers for selling lottery tickets and to video lottery agents for operation of video lottery facilities. Commission expense as a percent of sales remained relatively unchanged for all three years.

Gaming vendor fees and costs include costs of the central system used to monitor and collect pertinent data for the online and the video lottery system and costs of leasing video lottery terminals from gaming vendors. Gaming vendor fees and costs remained relatively unchanged as a percent of sales for all three years.

Vendors providing video lottery terminals pay a license fee for certain game themes to third parties. The Lottery splits the cost of these license fees with the racinos on a 50-50 basis, as the games are popular with the playing public. Franchise game fees in the table above represent the costs of these license fees, which have steadily increased over the three years as more franchise games have been added.

DELAWARE STATE LOTTERY
Management's Discussion and Analysis
June 30, 2008 and 2007

Prize Expense, Net of Reversions

Table 4
Prize Expense, Net of Reversions
(In millions)

	Year ended June 30		
	2008	2007	2006
Play 3	\$ 14.0	12.4	12.6
Play 4	7.0	8.3	8.3
Multi Win Lotto	3.9	3.9	4.2
Raffle	0.5	0.5	—
Powerball	15.5	13.7	18.4
Powerplay	1.6	1.5	1.4
Hot Lotto	1.0	—	—
Instant games	22.4	21.0	20.0
Total prize expense	<u>\$ 65.9</u>	<u>61.3</u>	<u>64.9</u>

Table 4 above compares prize expense for each lottery game category for the past three years. In general, prize expense by game will increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, the prize expenses for the Play 3 and Play 4 games are impacted by the luck of the draw and actual prize payment is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. Prize expense for the instant game product category is controllable for the most part, by printing a predetermined number and value of winning tickets for each instant game.

Prize expense for 2008 compared to 2007 and 2007 compared to 2006 is commensurate with the increases and decreases in traditional lottery sales during the same periods.

Operating Expenses

Table 5
Operating Expenses
(In millions)

	Year ended June 30		
	2008	2007	2006
Operating expenses	\$ 7.2	6.5	5.7

The \$0.7 million increase in operating costs for 2008 over 2007 was due to increases in advertising costs and the implementation of Government Accounting Standards Board Statement No. 45, which requires the Lottery to recognize the unfunded share of the State of Delaware's annual required contribution to the OPEB liability. The main reason for the \$0.8 million increase in 2007 when compared to 2006 was the discontinuation of All Cash Lotto reserves that resulted in a \$0.5 million decrease in operating expenses for 2006.

DELAWARE STATE LOTTERY
Management's Discussion and Analysis
June 30, 2008 and 2007

Nonoperating Expenses

Table 6
Nonoperating Expenses
(In millions)

	Year ended June 30		
	2008	2007	2006
Contributions to the State of Delaware:			
Standardbred breeder's program	\$ 3.0	3.0	3.0
Certified thoroughbred program	1.0	1.0	—
Contributions to the State of Delaware	<u>319.8</u>	<u>327.0</u>	<u>316.0</u>
Total nonoperating expenses	<u>\$ 323.8</u>	<u>331.0</u>	<u>319.0</u>

Increases and decreases in cash contributions to the State of Delaware were consistent with the Lottery's revenue increases and decreases.

DELAWARE STATE LOTTERY

Balance Sheets

June 30, 2008 and 2007

Assets	2008	2007
Current assets:		
Cash and cash equivalents	\$ 5,834,342	8,652,993
Accounts receivable, net of allowance of \$724,864 and \$724,864, respectively	14,940,036	12,492,244
Investments – restricted for payment of prize liabilities	1,698,921	2,052,815
Total current assets	22,473,299	23,198,052
Noncurrent assets:		
Capital assets, net	5,274	6,781
Investments – restricted for payment of prize liabilities	2,966,340	4,545,589
Deposit with Multi-State Lottery	2,122,417	1,683,048
Total noncurrent assets	5,094,031	6,235,418
Total assets	\$ 27,567,330	29,433,470
Liabilities and Net Assets		
Current liabilities:		
Prizes liability, including \$1,698,921 and \$2,052,815, respectively, of prize installment obligations	\$ 5,982,328	6,150,681
Accounts payable and accrued liabilities	9,729,664	8,491,160
Due to the State of Delaware	6,325,216	7,562,992
Total current liabilities	22,037,208	22,204,833
Noncurrent liabilities:		
Multi-State Lottery reserve	2,122,417	1,683,048
Prize installment obligations, noncurrent	2,966,340	4,545,589
OPEB liability	246,323	—
Total liabilities	27,372,288	28,433,470
Net assets:		
Invested in capital assets	5,274	6,781
Unrestricted	189,768	993,219
Total net assets	195,042	1,000,000
Total liabilities and net assets	\$ 27,567,330	29,433,470

See accompanying notes to financial statements.

DELAWARE STATE LOTTERY

Statements of Revenue, Expenses, and Change in Net Assets

Years ended June 30, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Revenue:		
Video lottery, net	\$ 611,538,875	635,676,294
Video lottery machine license fees	935,350	1,186,999
Video lottery performance surcharge	4,197,609	—
Video lottery expired jackpots and credit slips	674,782	—
Online games	89,338,486	85,196,546
Instant games	35,575,362	33,067,084
Total revenue	<u>742,260,464</u>	<u>755,126,923</u>
Cost of games:		
Video lottery commissions	291,035,697	302,239,827
Video lottery franchise game fees	4,245,659	3,100,349
Prize costs, net of reversions	65,895,722	61,324,989
Gaming vendor fees and costs	43,085,897	43,864,367
Online and instant games commissions	7,716,525	7,018,780
Sales aids	27,467	18,384
Total cost of games	<u>412,006,967</u>	<u>417,566,696</u>
Gross profit	<u>330,253,497</u>	<u>337,560,227</u>
Operating expenses:		
Advertising and promotions	2,768,974	2,484,138
Payroll and related benefits	2,073,357	1,832,546
Other general and administrative	2,372,808	2,165,275
Depreciation expense	1,507	62,049
Total operating expenses	<u>7,216,646</u>	<u>6,544,008</u>
Operating income	323,036,851	331,016,219
Nonoperating expenses:		
Contributions to the Delaware Standardbred Breeder's Program	3,000,000	3,000,000
Contributions to the Delaware Certified Thoroughbred Program	1,000,000	1,000,000
Contributions to the State of Delaware	319,841,809	326,959,769
Change in net assets	<u>(804,958)</u>	<u>56,450</u>
Net assets at beginning of year	1,000,000	943,550
Net assets at end of year	<u>\$ 195,042</u>	<u>1,000,000</u>

See accompanying notes to financial statements.

DELAWARE STATE LOTTERY

Statements of Cash Flows

Years ended June 30, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Cash flows from operating activities:		
Receipts from customers	\$ 739,812,672	750,170,844
Payments to vendors for goods and services	(52,788,299)	(49,823,459)
Payments to employees for services	(1,823,095)	(1,792,421)
Payments for prizes	(67,643,324)	(63,161,508)
Payments for commissions	(297,230,163)	(307,200,775)
Net cash provided by operating activities	<u>320,327,791</u>	<u>328,192,681</u>
Cash flows from noncapital financing activities:		
Contributions to the Delaware Standardbred Breeder's Program	(3,000,000)	(3,000,000)
Contributions to the Delaware Certified Thoroughbred Program	(1,000,000)	(1,000,000)
Contributions to the State of Delaware	(321,079,585)	(323,519,406)
Net cash used in noncapital financing activities	<u>(325,079,585)</u>	<u>(327,519,406)</u>
Cash flows from investing activity:		
Proceeds from maturity of investments	<u>1,933,143</u>	<u>1,857,320</u>
Net cash provided by investing activity	<u>1,933,143</u>	<u>1,857,320</u>
Net (decrease) increase in cash and cash equivalents	(2,818,651)	2,530,595
Cash and cash equivalents at beginning of year	<u>8,652,993</u>	<u>6,122,398</u>
Cash and cash equivalents at end of year	<u>\$ 5,834,342</u>	<u>8,652,993</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 323,036,851	331,016,219
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	1,507	62,049
Changes in operating assets and liabilities:		
Accounts receivable, net	(2,447,792)	(3,769,080)
Prepaid expenses	—	215,575
Deposit with Multi-State Lottery	(439,369)	40,280
Prizes liability	(1,747,602)	(1,836,519)
Accounts payable and accrued liabilities	1,924,196	2,464,157
Net cash provided by operating activities	<u>\$ 320,327,791</u>	<u>328,192,681</u>

See accompanying notes to financial statements.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

(1) Summary of Significant Accounting Policies

(a) *Legislative Enactment*

The Delaware State Lottery (the Lottery) was established by Enabling Legislation (the Legislation) passed on May 31, 1974, by the General Assembly of the State of Delaware (the General Assembly) under the authority of the Governor's Office and under the supervision of a Director. In July 1976, the Lottery was transferred to the Office of the Secretary of Finance. The Director has the power and duty to establish rules for conducting games, including the type and number of games, the price of tickets, the number and amounts of winning tickets, the manner of selecting winning tickets, the manner of prize payment, frequency of drawings, locations and methods for the sale of tickets, procedures for licensing of retailers, and all other functions related to the operation of the Lottery.

The Legislation provides that for the nonvideo lottery games, at least 45% of total revenue shall be used to pay prizes, operating expenses shall not exceed 20% of total revenue, and at least 30% of total revenue will be paid to the General Fund of the State of Delaware (the State). Enabling legislation for video lottery was enacted on July 16, 1994 and provides that for the video lottery games at least 87%, but not more than 95% (unless approved by the Director), of total proceeds on an average annual basis shall be used to pay prizes.

(b) *Reporting Entity*

The Delaware State Lottery (reporting entity) is an enterprise fund of the State of Delaware.

(c) *Basis of Presentation*

In accordance with accounting principles generally accepted in the United States of America, the financial statements are prepared on the accrual basis of accounting, which requires recognition of revenues when earned and expenses when incurred. The Lottery has elected not to apply all Financial Accounting Standards Board statements and interpretations issued after November 30, 1989, in accordance with Government Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*.

(d) *Cash and Cash Equivalents*

Cash and cash equivalents consist of deposits held in bank accounts and highly liquid overnight investment accounts, as well as deposits held by the State to fund future nonprize costs during the next month.

(e) *Accounts Receivable*

Accounts receivable consist primarily of unsettled balances due to the Lottery from the racetracks for video lottery, and from retailers, which principally include grocery and convenience stores serving as the primary distribution channel for traditional lottery sales (online and instant games) to the general public.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Receivables:		
Accounts	\$ 15,664,900	13,217,108
Total receivables	15,664,900	13,217,108
Allowance for doubtful accounts	(724,864)	(724,864)
Total receivables, net	\$ 14,940,036	12,492,244
Amounts not scheduled for collection during the subsequent year	\$ —	—

(f) Investments

Investments consist of annuity contracts purchased from insurance companies to fund future prize payments, and are carried at amortized cost as nonparticipating investment contracts. The practice of purchasing and holding annuity contracts to fund future prize obligations is no longer employed by the Lottery, as investment amounts reported represent annuity contracts whose most recent purchase was during 1998. It is the Lottery's policy to hold all investments of this nature that were purchased to fund prize obligations until maturity. All investments will have matured as of February 16, 2018, at which time such investments will no longer be reported by the Lottery.

(g) Capital Assets

All purchases of capital assets, mostly computer equipment and furniture and fixtures, in excess of \$15,000 are capitalized and carried at cost. Depreciation is computed by using the straight-line method over the estimated useful life of ten years. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal.

(h) Revenue Recognition

Revenue from online games is recognized on the day of the drawing. Revenue from the sale of instant tickets is recognized when the book has been activated and when one of the following occurs:

- 85% of the related prizes of an activated book is paid;
- 90 days from the date of activation; or
- when the next pack of the same game is activated.

Revenue from video lottery sales is recognized, net of prizes paid, at the time the public plays the game.

All revenue that the Lottery reports is considered operating revenue.

(i) Prize Obligations

Prize obligations for the online games are determined and recognized after each drawing is held. For the numbers games, winners are paid a certain amount depending upon the number of, or order of, winning numbers. Of every Multi Win Lotto sales dollar, a fixed payment goes to fund the nine

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

lower prize levels with the balance going into the jackpot. If there are no jackpot winners in the Lotto game, the amount is carried forward until there is a winner. For the Powerball, 50% of the revenues are allocated to the prize pool.

Prize obligations related to instant games are recognized by taking the greater of prize cash disbursements or the historical estimates of claimed prizes. Disbursements for prizes, including installment prize awards, are charged against the obligations for unpaid prize awards. Prizes unclaimed after one year revert back to the Lottery and reduce the prize costs for the year. Such unclaimed monies are then remitted to the State.

(j) *Compensated Absences*

The Lottery has accrued a liability included in accounts payable and accrued liabilities for future absences, recognizing the obligation relating to services already rendered. This liability represents benefits accrued to Lottery employees for vacation earned as of year-end and sick leave estimated to be paid out at retirement for services rendered as of June 30, 2008. Employees earn from 1.25 to 1.75 days of vacation leave per month depending on years of service. The employee or his estate is paid for unused vacation upon termination of employment. Employees earn 1.25 days of sick leave per month. The Lottery's obligation for sick leave credit is a maximum of 45 workdays. As of June 30, 2008 and 2007, the Lottery had liabilities of \$109,825 and \$106,319 for accrued vacation and \$137,760 and \$139,179 for accrued sick leave, respectively.

(k) *Operating and Nonoperating Expenses*

Operating expenses generally result from providing services and producing and delivering goods in connection with the Lottery's principal ongoing operations. Operating expenses of the Lottery include personnel costs, contracted services, supplies, and depreciation. All expenses not meeting this definition are reported as nonoperating expenses.

(l) *Pension and Postemployment Benefits*

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, became effective for the Lottery's fiscal year beginning July 1, 2007. GASB Statement No. 45 requires the Lottery to account for and report the value of its future other postemployment benefit (OPEB) obligations currently rather than on a pay-as-you-go basis. As discussed in note 11, the Lottery has no obligation at transition. The difference between the Lottery's share of the State of Delaware's Annual Required Contribution of \$396,266 and the expenses paid on behalf of the Lottery of \$149,943 resulted in a liability of \$246,323, which has been recorded as a liability and expensed in the current fiscal year.

(2) *Cash*

Cash and cash equivalents reported reflect three types of account balances: the Lottery deposit account, the Lottery prize account, and deposits held by the State. Cash receipts and all cash transfers to other state agencies are made in and out of the Lottery deposit account. Prize disbursements are made out of the Lottery prize account. Cash held by the State (Treasurer's Office), while identified for the Lottery, is maintained in an internal investment pool controlled by the State.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

Cash balances consisted of the following:

	June 30	
	2008	2007
On hand and in bank	\$ 3,553,585	6,298,462
Held by the State	2,280,757	2,354,531
	<u>\$ 5,834,342</u>	<u>8,652,993</u>

Custodial Credit Risk

All deposits are required by state law to be collateralized by direct obligations of, or obligations guaranteed by, the U.S. government or other suitable obligations as determined by the State's Cash Management Policy Board (the Board), unless the Board shall find such collateralization not in the best interest of the State. Additionally, the Board has determined that deposits need not be collateralized provided they are held in a bank that for the previous two years has had a return on total average assets of 0.5% or greater and has had an average capital ratio (total equity to total assets) of at least 5.0%. If the bank does not meet the aforementioned criteria, collateral must consist of one or more of the following:

- U.S. government securities;
- U.S. government agency securities;
- Federal Home Loan Board letters of credit;
- State securities; or
- Securities of a political subdivision of the State with a Moody's Investors service rating of "A" or better.

In addition, the bank must ensure that those securities pledged as collateral have a market value equal to or greater than 102% of the ledger balance(s) in the account(s) each day and ensure that securities pledged are identified as held in the State's name and are segregated on the bank's records.

At June 30, 2008 and 2007, the bank in which amounts representing deposits and cash on hand are maintained met the aforementioned state-mandated standards, thus alleviating the need for collateralization. Also, at June 30, 2008 and 2007, the financial institutions maintaining the State's internal investment pool satisfied the aforementioned criteria; thus, the investments managed by those institutions do not require collateralization.

As of June 30, 2008 and 2007, the total bank balance of cash in all bank accounts was \$3,642,861 and \$6,323,030, respectively.

(3) Investments

Until April 1998, annuity contracts were purchased from insurance companies to fund prizes of \$150,000 or more; payable on an installment basis. All investments reported on the balance sheet represent such annuities, and are carried on the balance sheet at amortized cost. The fair value of some of these investments is not easily determinable; however, it is the Lottery's intent to hold the investments until maturity. The Lottery remains liable for future periodic payments of deferred prize obligations (approximately \$4.7 million as of June 30, 2008) in the event that annuity issuers default on their

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

obligations. Lottery investments as of June 30, 2008 and 2007 are considered uncategorized investments as it relates to custodial credit risk under GASB Statement No. 40, *Deposit and Investment Risk Disclosures*.

(a) *Interest Rate Risk*

Interest rate risk is the risk that changes in interest rates of debt instruments will adversely affect the value of an investment. Investments reported on the balance sheet are not subject to interest rate risk.

(b) *Credit Risk and Concentration of Credit Risk*

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. While the Lottery no longer utilizes the purchase of annuity contracts to fulfill prize obligations, the Lottery places no limit on the amount it may invest in any one issuer. As of June 30, 2008, the insurance companies with which the Lottery's investments in annuity contracts to pay future prize obligations are held were rated by A.M. Best Company and concentrated as follows:

<u>Insurance company</u>	<u>Total annuity contract values</u>	<u>Concentration</u>	<u>A.M. Best rating</u>
Sun America Life Insurance Company	\$ 81,362	1.74%	aa (superior)
Jefferson-Pilot Life Insurance Company	2,234,450	47.90	nr (not rated)
Metropolitan Life Insurance Company	1,286,134	27.57	aa (superior)
Mutual of America Life Insurance Co.	384,611	8.24	aa- (superior)
New York Life Insurance Company	275,828	5.91	aaa (superior)
Ohio National Life Insurance Company	402,876	8.64	aa- (superior)
Total investments in annuity contracts	\$ 4,665,261	100.00%	

(4) *Capital Assets*

	<u>Beginning balance July 1, 2007</u>	<u>Increase</u>	<u>Decrease</u>	<u>Ending balance June 30, 2008</u>
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	—	—	1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,388,106	1,507	—	1,389,613
Total capital assets being depreciated, net	\$ 6,781	(1,507)	—	5,274

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

	Beginning balance July 1, 2006	Increase	Decrease	Ending balance June 30, 2007
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	—	—	1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,326,057	62,049	—	1,388,106
Total capital assets being depreciated, net	\$ 68,830	(62,049)	—	6,781

During the years ended June 30, 2008 and 2007, the Lottery had no purchases or disposals of capital assets. Depreciation expense for the years ended June 30, 2008 and 2007 was \$1,507 and \$62,049, respectively.

(5) Prize Obligations

The following is a reconciliation of changes in the prize liability account, which includes the present value of prize installment obligations, for the fiscal years ended June 30, 2008 and 2007:

	2008	2007
Prize obligations, beginning of year	\$ 10,696,270	12,532,789
Prize payments	(67,643,324)	(63,161,508)
Prize costs, net of reversions	65,895,722	61,324,989
Prize obligations, end of year	\$ 8,948,668	10,696,270

The Lottery pays the winners of certain jackpots in annual installments over periods that vary generally from 14 to 20 years. The future prize installment obligations payable as of June 30, 2008, and during the next five years and thereafter, are as follows:

2009	\$ 1,837,200
2010	1,384,575
2011	949,800
2012	666,625
2013	273,125
Thereafter	218,375
Total payments for unpaid prize installment obligations	5,329,700
Less imputed interest	(664,439)
Present value of prize installment obligations	\$ 4,665,261

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

(6) Participation in the Multi-State Lottery

The Lottery is a member of the Multi-State Lottery (the MUSL), which operates online games on behalf of participating state lotteries. Each MUSL member sells game tickets through its agents and makes weekly wire transfers to the MUSL in an amount equivalent to the member's share of the estimated grand prize liability. Each MUSL member pays lesser prizes directly to the winners. The MUSL operates the Powerball games, as well as the Powerplay feature associated with Powerball. The MUSL also operates the Hot Lotto game, in which the Lottery began participating during fiscal year 2008. Participating lotteries are required to maintain deposits with MUSL for contingency reserves to protect MUSL from unforeseen prize liabilities. The money in this reserve fund is refundable to MUSL members if the MUSL disbands or if a member leaves the MUSL Board.

The amount the Lottery had on deposit with the MUSL, as of June 30, 2008 and 2007, equaled \$2,122,417 and \$1,683,048, respectively. These amounts are also reported as a liability on Lottery's balance sheet because they represent the amount to be paid to the State upon separation from the MUSL if the MUSL is not required to use a portion of the Lottery's reserves held by the MUSL.

Complete separate financial statements for the MUSL may be obtained by sending a written request to the Lottery's Administrative Office.

(7) Delaware Standardbred Breeder's Program and Delaware Certified Thoroughbred Program

In March 1998, an amendment to the Legislation was passed by the General Assembly that established the Delaware Standardbred Breeder's Program (the Breeder's Program) for the purpose of promoting the Delaware harness racing industry. Under this amendment, the Lottery was initially required to withhold \$2,000,000 of funds annually (\$1,000,000 from the General Fund of the State and \$1,000,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program. Under an amendment signed in April 2004, the Lottery is required to withhold \$3,000,000 of funds annually (\$1,500,000 from the General Fund of the State and \$1,500,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program.

In the epilogue language of the Fiscal Year 2006 Bond Bill, an amendment was passed by the General Assembly that established the Delaware Certified Thoroughbred Program for the purpose of enhancing the quantity of thoroughbred foals and/or yearlings stabled within Delaware. Under this amendment, effective July 1, 2006, the Lottery is required to withhold \$1,000,000 of funds annually (\$500,000 from the General Fund of the State and \$500,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these funds to the Delaware Certified Thoroughbred Program.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

(8) Contributions to the State of Delaware

As required, under the Legislation, net assets of the Lottery may not exceed \$1,000,000; therefore, the Lottery periodically transfers surplus funds to the State in accordance with the Legislation. For the years ended June 30, 2008 and 2007, the Lottery made the following contributions to the State and, as of June 30, 2008 and 2007, had the following liabilities due to the State for excess earnings:

	June 30	
	2008	2007
Amounts transferred during the fiscal year:		
General Fund	\$ 252,500,000	256,700,000
Department of Health and Social Services	1,718,462	1,919,230
Department of Agriculture	66,861,123	64,900,176
	<u>321,079,585</u>	<u>323,519,406</u>
Amounts accrued, beginning of year	<u>(7,562,992)</u>	<u>(4,122,629)</u>
Amounts due to the State of Delaware, end of year:		
General Fund	(246,323)	—
Department of Health and Social Services	161,321	162,724
Department of Agriculture	6,410,218	7,400,268
Amounts accrued, end of year	<u>6,325,216</u>	<u>7,562,992</u>
Total contributions to the State of Delaware	\$ <u><u>319,841,809</u></u>	<u><u>326,959,769</u></u>

(9) Revenue and Expenses by Game

The following revenue was recognized:

	Year ended June 30	
	2008	2007
Online games:		
Play 3 Day	\$ 9,857,887	9,768,918
Play 3 Night	16,902,911	17,102,103
Play 4 Day	6,052,812	6,150,303
Play 4 Night	11,278,803	11,474,098
Multi Win Lotto	7,140,130	7,081,815
Hot Lotto	1,586,555	—
Raffle	998,430	999,780
Powerball	32,229,600	29,510,089
Powerplay	3,291,358	3,109,440
	<u>89,338,486</u>	<u>85,196,546</u>
Video lottery, net	611,538,875	635,676,294
Video lottery machine license fees	935,350	1,186,999
Video lottery performance surcharge	4,197,609	—
Video lottery expired jackpots and credit slips	674,782	—
Instant	35,575,362	33,067,084
	\$ <u><u>742,260,464</u></u>	<u><u>755,126,923</u></u>

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

The revenue, prize costs, and commissions expense, by game type, are listed below:

	<u>Online</u>	<u>Video lottery, net</u>	<u>Instant</u>	<u>Total</u>
Year ended June 30, 2008:				
Revenue	\$ 89,338,486	611,538,875	35,575,362	736,452,723
Other income	—	5,807,741	—	5,807,741
Prize costs, net of reversions	<u>43,540,991</u>	<u>—</u>	<u>22,354,731</u>	<u>65,895,722</u>
	45,797,495	617,346,616	13,220,631	676,364,742
Commissions expense	<u>5,665,549</u>	<u>291,035,697</u>	<u>2,050,976</u>	<u>298,752,222</u>
Contribution margin per game	<u>\$ 40,131,946</u>	<u>326,310,919</u>	<u>11,169,655</u>	<u>377,612,520</u>
Year ended June 30, 2007:				
Revenue	\$ 85,196,546	635,676,294	33,067,084	753,939,924
Other income	—	1,186,999	—	1,186,999
Prize costs, net of reversions	<u>40,360,969</u>	<u>—</u>	<u>20,964,020</u>	<u>61,324,989</u>
	44,835,577	636,863,293	12,103,064	693,801,934
Commissions expense	<u>5,120,691</u>	<u>302,239,827</u>	<u>1,898,089</u>	<u>309,258,607</u>
Contribution margin per game	<u>\$ 39,714,886</u>	<u>334,623,466</u>	<u>10,204,975</u>	<u>384,543,327</u>

(10) Payroll-Related and Other Benefits

All Lottery personnel are employees of the State and are covered by pension, health insurance, and other employee benefit programs administered by agencies of the State. During 2008 and 2007, the Lottery incurred \$2,073,357 and \$1,832,546, respectively, of payroll-related costs, including pension, health insurance, and other employee benefit costs, paid to various state agencies responsible for the administration of benefit programs.

(11) Retirement and Other Postemployment Benefits

(a) Retirement

The Lottery contributes to the State Employees' Pension Plan (the State Plan) established by the State to provide benefits for state employees. While the State Plan is an agent multiple employer public employee retirement system, the Lottery accounts for the plan as a cost-sharing multiple employer public employees retirement system since a separate valuation is not performed for the Lottery and the Lottery's only obligation to the plan is its required annual contributions. The State Plan is considered part of the State's financial reporting entity, and is not considered as part of the Lottery's reporting entity. The State Plan prepares separate financial statements, which can be obtained by writing to the State Board of Pension Trustees and Office of Pensions, McArdle Building, Suite #1, 860 Silver Lake Boulevard, Dover, Delaware 19904-2402.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

The State Plan consists of several plans, which are managed by the State. The various plans have different vesting periods ranging from 5 to 20 years, various eligibility requirements, and various benefits that are provided. The Lottery's required contributions, which equaled actual contributions made for the years ended June 30, 2008, 2007, and 2006, were \$193,867, \$187,006, and \$162,331, respectively.

The Lottery's accrued pension costs for the years ended June 30, 2008 and 2007 equaled \$11,231 and \$11,205, respectively, and are included within amounts reported as accounts payable and accrued liabilities on the balance sheets.

(b) Other Postemployment Benefits

All full-time Lottery employees are covered under the State of Delaware Other Post-Employment Benefits Fund Trust (the OPEB Trust), which was established pursuant to Section 115 of the Internal Revenue Code and administered by the Delaware Public Employees' Retirement System. No stand-alone financial report is issued for the OPEB Trust, but the Trust is included in the statewide Comprehensive Annual Financial Report, which will be available from the Division of Accounting.

The OPEB Trust provides retirement medical coverage to 16,644 pensioners and their eligible dependents through the same health care plans that are available to active employees. Retirees' contributions depend on date of hire and years of service and range from 0 to 100% of the cost. There are currently 35,019 active eligible plan members. The Lottery has 29 active eligible plan members, which is the basis on which plan costs are allocated.

By State statute Title 29 of the Delaware Code c.52, contribution requirements of plan members and the government are established and may be amended by the State Legislature. The contribution rates for the employer and retiree are established annually by the budgeting process of the State of Delaware, but are not actuarially determined. Those rates include an employer contribution based on projected pay-as-you-go financing requirements, with an additional amount to prefund benefits, which was 0.54% of payroll in 2008.

The State's annual OPEB cost is calculated based on the actuarially determined annual required contribution of the employer (ARC). The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize the unfunded actuarial liabilities over a period of 30 years. Amounts "required" but not actually set aside to pay for these benefits are accumulated as part of the Net OPEB obligation. The following table shows the

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2008 and 2007

components of the annual OPEB cost for the year, the amount actually contributed to the plan, and the net OPEB obligation, as well as the amounts allocated to the Lottery:

	State total (in millions)	Lottery allocation (in thousands)
Net OPEB obligation as of June 30, 2007	\$ —	—
Annual required contribution	464.6	396.3
Adjustment to required contribution	—	—
Annual OPEB cost	464.6	396.3
Employer contributions	(183.2)	(149.9)
Net OPEB obligation as of June 30, 2008	\$ 281.4	246.4

The State's actuarial accrued liability for benefits was \$5,489 million, and the actuarial value of assets was \$79 million, resulting in an unfunded actuarial accrued liability (UAAL) of \$5,410 million for the primary government. The Lottery's share of the UAAL is \$4.4 million.

(12) Risk Management

The Lottery stipulates in its vendor contracts that the vendors carry various insurance coverages such as property (video gaming machines and online terminals, etc.), general liability, errors and omissions, automotive, and crimes. The Lottery's risks of losses related to workers' compensation, employee healthcare, automobile, and a portion of property and casualty claims are insured internally by the State.

(13) Commitments

The Lottery has entered into various contracts for services to be rendered relating principally to the operation of the Lottery's games. Under the gaming systems vendor contracts, the Lottery is committed to the vendors.

The Lottery is committed to 4.18% of online sales to its central system provider through February 2015 and 7.8987% of instant sales through November 2011. For video lottery, the Lottery is committed to 1% to the central system provider through February 2015 and a percentage ranging from 4.0% to 6.5% to the video lottery terminal providers through June 1, 2011.

The Lottery's commitments to gaming vendors, as described above, comprise the majority of the following commitments. The commitments to gaming vendors included in these commitments are based on management's sales projections for the respective years, as follows:

2009	\$ 47,112,100
2010	46,401,750
2011	44,679,800
2012	12,732,600
2013	10,896,700
Thereafter	18,578,500
	<u>\$ 180,401,450</u>



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**Independent Auditors' Report on Internal Control Over Financial Reporting and on
Compliance and Other Matters Based on an Audit of Financial Statements Performed in
Accordance With *Government Auditing Standards***

Wayne Lemons, Director of the Delaware State Lottery and
Richard S. Cordrey, Secretary of Finance, State of Delaware:

We have audited the financial statements of the Delaware State Lottery (the Lottery) as of and for the year ended June 30, 2008, and have issued our report thereon dated December 15, 2008, which included an explanatory paragraph on the adoption of GASB 45. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Lottery's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Lottery's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.



Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the Lottery in a separate letter dated December 15, 2008.

This report is intended solely for the information and use of the Secretary of Finance, Lottery Management, the Office of the Governor, the Office of the Controller General, the Office of the Attorney General, the Office of Management and Budget, and the Office of the Auditor of Accounts and others within the entity, and is not intended to be and should not be used by anyone other than these specified parties. However, under 29 Del. C, Section 0102(d), this report is public record and its distribution is not limited.

KPMG LLP

December 15, 2008